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IN THE
Supreme Court of the United States
OCTOBER TERM, 1998

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM, *et al.*,
Petitioners,

v.

PAUL FELZEN, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF OF WASHINGTON LEGAL FOUNDATION AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

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QUESTION PRESENTED

Whether a nonparty shareholder who appears, in response to notice provided under Federal Rule of Civil Procedure 23.1, to present objections to a proposed dismissal or settlement of a derivative action may appeal an adverse decision even though the shareholder has not been formally made a party to the action.

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INTEREST OF *AMICUS CURIAE*

The Washington Legal Foundation (WLF) is a nonprofit public interest law and policy center based in Washington, D.C., with supporters across the nation.[1] WLF regularly appears in legal proceedings before federal and state courts, as well as administrative bodies, to defend the principles of free enterprise and limited government.

WLF has devoted substantial resources to promote civil justice reform. Through litigation and publishing it has endeavored to prevent excessive litigation from impeding this nation's economic growth. To that end, WLF has appeared before this Court and other federal and state courts in several cases. *See, e.g.*, *Matsushita Electric Industrial Co. v. Epstein*, 116 S. Ct. 873 (1996) (the proper scope of class action litigation); *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993) (use of expert scientific evidence in litigation).

WLF is filing the attached brief because of its ongoing interest in promoting the welfare of the business community and the public at large. It has no direct economic interest in the outcome of this lawsuit or in other suits raising similar issues. For that reason, WLF believes that it can assist the Court by supplying a disinterested perspective that is distinct from that of any party. All parties have consented to the filing of this brief, and their letters of consent have been lodged with the Clerk of the Court.

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[1] Pursuant to Supreme Court Rule 37.6, the Washington Legal Foundation states that no counsel for a party authored this brief in whole or in part; and that no person or entity, other than the Washington Legal Foundation and its counsel, contributed monetarily to the preparation and submission of this brief.

STATEMENT OF THE CASE

In the interests of brevity, WLF hereby incorporates by reference the Statement of the Case contained in the Brief for Respondents.

This case arose when Archer Daniels Midland Company (ADM) suffered financial losses brought on by two causes.

First, ADM suffered severe financial losses when it became the target of a federal criminal investigation. On October 15, 1996, ADM pleaded guilty to criminal antitrust charges for conspiring with rivals to fix prices for citric acid, high fructose corn syrup, and lysine. As a penalty, the court imposed on ADM the largest criminal antitrust fine in history: $100 million. And this price tag, while enormous, described only part of ADM's burden. ADM paid out another $90 million to settle three civil antitrust actions, which its competitors brought as a direct result of the criminal probe.

Second, ADM suffered losses from alleged mismanagement. Journalists, industry analysts, and a major shareholder publicly criticized ADM for maintaining allegedly overly close ties between management and members of the board, whose duties included overseeing management. *See, e.g.*, John A. Byrne, *The Best and the Worst Boards*, Bus. Wk., Nov. 25, 1996; Roger Lowenstein, *Corporate Governance's Sorry History*, Wall St. J., Apr. 19, 1996, at C2; Martha Irvine, *Guilty Verdict May Change Plans for Top Management at Agribusiness*, Assoc. Press, Sept. 20, 1998; Greg Burns, *A Grain of Activism at Archer Daniels Midland*, Bus. Wk., Nov. 6, 1995, at 44.

ADM responded to these criticisms and to its antitrust troubles by commissioning a report proposing reforms to ADM's corporate governance. Adopted in January 1996, these reforms required the board to include a majority of independent members. But adopting the report did not put an end to the criticism of ADM. Major ADM shareholders, including Petitioners California Public Employees' Retirement System (CalPERS) and the Florida State Board of Administration (SBA), unsuccessfully challenged the proposed reforms.

As a result of the criminal probe and the public criticisms of ADM's governance practices, several shareholder derivative actions were filed on behalf of ADM. These were consolidated by May 1996 in the United States District Court for the Central District of Illinois. The consolidated action accused ADM's directors of "gross mismanagement" Br. Pet. at 5, for failing to properly supervise corporate employees. Plaintiffs sought to recover the $190 million ADM had been obligated to pay in criminal fines and civil settlements because of the antitrust conviction.

On May 29, 1997, plaintiffs' counsel and the insurance company covering ADM and its board members arrived at a settlement. It required the defendants to pay $8 million in exchange for a release of "any and all causes of action" against the defendants. The parties agreed that the entire amount would be allocated for attorneys fees. Roughly half was to be paid to plaintiffs' counsel, and the other half was to be reserved for ADM's future legal expenses, incurred as a consequence of carrying out the corporate reforms described in the settlement. These reforms included a restructuring of the board and procedures to enhance director independence. Professor John C. Coffee, Jr.,

who was "retained by the plaintiffs' attorneys to apprise the adequacy and significance of the corporate governance provisions," Joint App. at 225, contained in the settlement, characterized the reforms as "more or less the 'state of the art' in American corporate governance today." Joint App. at 226.

After executing this settlement, the parties and defendants filed a written motion seeking approval of the settlement from the district court. On May 30, 1997, the court issued an Order Preliminarily Approving Settlement and Providing for Notice. The order directed the parties to give all ADM shareholders written notice of the proposed settlement. Along with that notice came an order to show cause, offering nonparty shareholders an opportunity to present objections to the settlement.

On July 7, 1997, the district court approved the settlement and entered judgment accordingly. CalPERS and SBA filed a timely notice of appeal to the United States Court of Appeals for the Seventh Circuit, but they did not intervene in the action.

Some Respondents filed a motion in the United States Court of Appeals for the Seventh Circuit, seeking dismissal of the appeal. They argued that CalPERS and SBA could not appeal from the district court's judgment approving the settlement, because they had not intervened as parties. The court agreed.

The Seventh Circuit dismissed the Respondents' appeal for want of jurisdiction. *See* Pet. App. at 10a. Judge Easterbrook, writing for a unanimous panel that also included Chief Judge Posner and Judge Flaum, decided that shareholders who have been summoned to present objections to a proposed settlement in a

derivative action must intervene if they wish to appeal an adverse decision. *See id.* at 2a, 7a.

The Seventh Circuit's analysis primarily relied on a statement this Court made in *Marino v. Ortiz*, 484 U.S. 301 (1988): "The rule that only parties to a lawsuit, or those that properly become parties, may appeal an adverse judgment, is well settled." *Id.* at 304 (citations omitted). Although this statement from *Marino* arose out of an appeal from a consent decree in a class action, the appeals court pointed out that it had already expanded the application of *Marino* beyond that narrow context. In *In re Brand Name Prescription Drugs Antitrust Litigation*, 115 F.3d 456 (7th Cir. 1997), it held that an unnamed member of a class in a class action may not appeal from a summary judgment order granted in favor of a defendant. For that reason, the Seventh Circuit couched the issue in this case in terms of whether objecting nonparty shareholders in a derivative action deserved what unnamed class members in a class action did not deserve, namely, treatment as an exception to the "only parties may appeal" rule of *Marino*. For several reasons, the panel concluded that such shareholders did not merit an exception to *Marino*.

First, the Seventh Circuit cited fidelity to this Court's precedent as a reason not to carve out an exception to *Marino*. There this Court explained that "the better practice," 484 U.S. 301, 304 (1988), when a nonparty has a legal interest that a district court decision will affect, is to "seek intervention for purposes of appeal." *Id.* On this basis, the Seventh Circuit interpreted *Marino* to mean that federal circuit courts lack the authority to make exceptions to the rule that "only parties may appeal adverse judgments." *See* Pet. App. at 3a.

Second, the lower court cited Rule 3(c) of the Federal Rules of Appellate Procedure in support of *Marino*. If "[a] notice of appeal must specify the party or parties taking the appeal," *Id.*, the court reasoned, then only parties may appeal. *See* Pet. App. at 2a.

Third, the Seventh Circuit rejected the argument that because "erroneous decisions should be reversed," Pet. App. at 3a, intervention is unnecessary. As the court emphasized, "A court of appeals is not an ombudsman." *Id.* Erroneous district court judgments "do not justify omitting the step of intervening as a party." *Id.*

Finally, the Seventh Circuit panel rejected the argument that the distinction between nonparty shareholders in a derivative suit and unnamed plaintiffs in a class action justifies a right of appeal for the former if not the latter. As the panel keenly observed, such a distinction "cut[s] against," Pet. App. at 4a, the nonparty shareholders' position. "[E]ach class member has a real grievance with the defendant that sets up at least an equitable argument for a class member who wants to appal. But in a shareholders' derivative action, the individual investor is not an injured party and is not entitled to litigate. . . ." *Id.* at 4a-6a (citations omitted).

The circuit panel acknowledged that its own pre-*Marino* precedent had allowed nonparty shareholders in a derivative action to appeal without intervening. *See Tryforos v. Icarian Development Co.*, 518 F.2d 1258, 1263 n.22 (7th Cir. 1975). However, the court decided to overrule *Tryforos*. In its judgment, not only did *Tryforos* fail to explain why nonparty shareholders possess the right to appeal without intervening, but

it predated this Court's pronouncement in *Marino*. *See* Pet. App. at 3a.

The court below also recognized that its reasoning put it at odds with the Third Circuit's decision in *Bell Atlantic Corp. v. Bolger*, 2 F.3d 1304 (3rd Cir. 1993). There the court held that a shareholder need not intervene to appeal from a district court's decision to accept settlement of a derivative action. *See id.* at 1307-10. The Third Circuit reached this conclusion on the ground that shareholders have standing. The Seventh Circuit disagreed. It argued that *Marino* requires circuit courts to treat a shareholder's status as a party or nonparty, not the injury it can show, as dispositive in determining whether a particular shareholder may appeal from an adverse decision in the district court. "Equating injury with party status is exactly the approach disapproved by *Marino*." Pet. App. at 7a.

SUMMARY OF ARGUMENT

Shareholder derivative actions play an important role in the American economy. According to some commentators, they serve as "the primary mechanism for enforcing the fiduciary duties of corporate managers." Reinier Kraakman *et al.*, *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733, 1733 (1994). At the same time, however, "shareholder derivative suits have been controversial since their inception." Carol B. Swanson, *Corporate Governance: Sliding Seamlessly into the Twenty-first Century*, 21 J. CORP. LAW 417, 437 (1996).

The Question Presented requires this Court to decide whether shareholder derivative litigation shall be conducted according to the Federal Rules of Civil Procedure, or not. The Seventh Circuit held that since

"only parties to a lawsuit, or those that properly become parties, may appeal an adverse judgment," *Marino v. Ortiz*, 484 U.S. 301, 304 (1988), nonparty shareholders may not, by definition, appeal from a district court decision accepting a proposed settlement of the consolidated derivative action brought against ADM's directors and officers. *See* Pet. App. at 2a, 7a. That decision finds strong support in both policy and law.

From the viewpoint of policy, granting nonparty shareholders a right of appeal to contest adverse settlement decisions undermines the purpose of derivative actions. Derivative actions were designed to permit shareholders to bring an action to prevent a corporation from being economically destroyed by faithless fiduciaries. Their useful purpose is undermined, however, if derivative actions are permitted to be extended too far. Derivative actions, as with any species of litigation, impose large costs on corporations. Deciding how extensively nonparty shareholders may participate in derivative actions is a potentially ticklish question, which has fortunately been decided by those who drafted and enacted Rule 23.1.

Rule 23.1 nowhere contains a right of appeal for nonparty shareholders wishing to contest a district court's decision to approve the settlement of a derivative action. For various policy reasons, Petitioners and their *amici* invite this Court to create one where the drafters of Rule 23.1 saw fit not to. Such judicial creativity is unnecessary because the rule provides adequate protection against the same evils, namely, unfair or collusive settlements, which Petitioners' newly-minted right of appeal would supposedly provide. In addition, declining Petitioners' invitation would be in keeping with this Court's oft-stated commitment

to eschew judicial legislation when construing the Federal Rules of Civil Procedure. If Petitioners and their *amici* are correct in arguing that Rule 23.1 needs to include a right of appeal for nonparty objecting shareholders, then amendment ought to be left to the rulemaking procedure prescribed by Congress.

ARGUMENT

I. GRANTING NONPARTY SHAREHOLDERS THE RIGHT TO APPEAL WITHOUT INTERVENING UNDERMINES THE PURPOSE OF DERIVATIVE ACTIONS.

A. Shareholder Derivative Actions Serve the Purpose of Protecting Corporations from Economic Loss Caused by Faithless Fiduciaries.

"Devised as a suit in equity, the purpose of the derivative action was to place in the hands of the individual shareholder a means to protect the interests of the corporation from the misfeasance and malfeasance of 'faithless directors and managers.'" *Kamen v. Kemper Financial Services, Inc.*, 500 U.S. 90, 95 (1991) (quoting *Cohen v. Beneficial Loan Corp.*, 337 U.S. 541, 548 (1949)). "Such suits often allege that an officer or director has breached his duty of loyalty; in other words, that the manager has effectively 'cheated' the company by self-dealing, accepting kickbacks, appropriating a corporate opportunity, wasting corporate assets, or entrenching his position to avoid removal." Reinier Kraakman *et al.*, *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733, 1733 (1994) (footnote omitted). The narrow range of legal interests protected by derivative actions is sometimes misunderstood.

CalPERS and SBA complain that under the terms of the proposed settlement, "Not one dime [would be] returned to the corporation for the benefit of shareholders who lost at least $190 million in value as a result of their fiduciaries' misconduct." Br. Pet. at 7. In its brief supporting CalPERS and SBA, the United States claims that a nonparty objecting shareholder in a derivative action has personal legal rights at stake in the action. "Rule 23.1 protects absent shareholders from settlements that unfairly compromise their interests by providing them with notice and an opportunity to object to settlements and by requiring court approval of settlements." Br. United States & SEC As *Amici Curiae* Supp. Pets. [*hereinafter* Br. U.S.] at 19; *see also id.* at 16 ("Rule 23.1 specifically recognizes the shareholder's personal rights . . . ."); *Id.* at 18 ("[T]he objecting shareholder has a personal stake in the outcome of a derivative action settlement."). These assertions of shareholder interests in the face of multimillion-dollar corporate losses are entirely understandable. However, they have led Petitioners and their *amici* to misunderstand the nature of derivative actions.

Derivative actions protect the corporation from the economic injuries caused by disloyal fiduciaries. Such injuries take many forms, including the criminal penalties, civil settlement costs, and loss of shareholder confidence at issue in this case. *See* Br. Pet. at 2-4. These injuries will likely cause the value of a corporation's shares to fall. But derivative actions are not designed to remedy a shareholder's personal financial loss in such circumstances. *Papilsky v. Berndt*, 466 F.2d 251 (2nd Cir. 1972). As Justice Frankfurter long ago emphasized, "The contrasting difference between a stockholder's suit for his corporation and a suit by him against it, is crucial." *Smith v. Sperling*,

354 U.S. 91, 99 (1957) (Frankfurter, J., dissenting). His explanation of the distinction, though somewhat lengthy, is worthwhile for its clarity:

> In the former, [the stockholder] has no claim of his own; he merely has a personal controversy with his corporation regarding the business wisdom or legal basis for the latter's assertion of a claim against third parties. Whatever money or property is to be recovered would go to the corporation, not a fraction of it to the stockholder. When such a suit is entertained, the stockholder is in effect allowed to conscript the corporation as a complainant on a claim that the corporation, in the exercise of what it asserts to be its uncoerced discretion, is unwilling to initiate. This is a wholly different situation from that which arises when the corporation is charged with invasion of the stockholder's independent right. Thus, for instance, if a corporation rearranges the relationship of different classes of security holders to the detriment of one class, a stockholder in the disadvantaged class may proceed against the corporation as a defendant to protect his own legal interest.

Id.; *see also Koster v. Lumbermen's Mut. Cas. Co.*, 330 U.S. 518, 522 (1947) (comparing derivative actions with suits brought on behalf of a "next friend" when the real party in interest cannot protect itself).

Derivative actions serve a legitimate purpose by protecting the corporation from the economic damage inflicted by faithless fiduciaries. Such actions protect the interests of a corporation, considered apart from the interests of shareholders, directors, and officers.

For that reason, it is inaccurate for Petitioners and their *amici* to speak of "shareholders' interests" in the context of a derivative action. As the name suggests, such an action *derives* from the interests of the corporation. *See Kearney v. Jandernoa*, 934 F. Supp. 863, 867 (W.D. Mich. 1996). And it is those interests, not the interests of shareholders, which ought to govern in any discussion of the policies underlying the procedures by which derivative actions are maintained in the federal courts.

B. Derivative Actions Impose Significant Economic Losses on Corporations in the Form of Litigation Costs.

In permitting shareholders to protect a corporation's interest by bringing an action against delinquent fiduciaries, derivative actions serve a useful, indeed at times essential, purpose. But derivative actions, like any other kind of litigation, cost substantial amounts of time and money. A balanced appraisal of the right to appeal sought by CalPERS and SBA must take account of that fact.

To evaluate the cost of derivative actions to a corporation, one must start with the fact that "plaintiffs [in derivative and class actions] are generally figureheads .... because the real incentive for bringing such actions is the quest for attorney's fees." Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 948 (1993). Because attorneys fees lie at the heart of how derivative suits are conducted, they account for a large portion of any settlement recovered on behalf of the corporation. *Cf.* J. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV.

497, 573 (1991) (suggesting that for every dollar awarded to shareholders in securities law class actions, another dollar goes toward litigation costs).

That derivative litigation is largely driven by the "quest" for attorneys fees largely accounts for its high cost to corporations. *See* Reinier Kraakman *et al.*, *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733, 1738 n.15 (1994). *see also* A.F. Conard, *Winnowing Derivative Suits Through Attorneys Fees*, 47 LAW & CONTEMP. PROBS. 269, 281-82 (1984) (noting that multimillion dollar derivative suits, coupled with the contingency fees customary in such suits, "inspire [the] filing [of] some long-shot lawsuits."). Multimillion dollar attorneys fee awards are not uncommon in these cases. *See, e.g., In re Pacific Enterprises Secs. Litig.*, 47 F.3d 373, 376 (9th Cir. 1995) (awarding $4 million in attorneys fees); *Granada Investments, Inc. v. DWG Corp.*, 962 F.2d 1203, 1207 (6th Cir. 1992) (awarding $4.1 million in attorneys fees).

Not all the high cost of derivative litigation can be measured in dollars, however. Some of the cost comes in the form of "time and energy." 82 GEO. L.J. 1733, 1738 (1994). Other indirect costs include "loss of morale, deflection of employee time, and injury to the corporate reputation." James D. Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation*, 1982 DUKE L.J. 959, 960.

C. Extending the Particiation of Nonparty Shareholders by Creating a Right to Appeal Without Intervening Would Undermine the Purpose of Derivative Actions by Imposing Greater Litigation Costs on the Corporation.

Granting nonparty shareholders the right to appeal sought by CalPERS and SBA extends the life of a derivative action by delaying a settlement that would otherwise bring that action to an end. And extending the action increases litigation costs. Thus, at some point, granting nonparty shareholders a right to appeal without intervening from a decision to accept a settlement in a derivative action threatens to undermine the purpose of derivative actions themselves.

Writing in support of CalPERS and SBA, the Council of Institutional Investors asserts that corporations receive financial benefits from the improvements that nonparty objecting shareholders brings to the settlement hearing. *See* Brief of *Amicus Curiae* Council of Institutional Investors in Support of Petitioners [*hereinafter* Br. Council] at 15-16. Their analysis appears to assume that reducing the portion of the settlement devoted to attorneys fees necessarily benefits the corporation. On this point they are mistaken.

As some commentators have observed, even a legitimate derivative action may not yield a net financial gain to the corporation.

> The litigation costs imposed on the firm may well exceed the damages awarded even in successful suits. Some derivative suits are based on public policy issues and, if won, clearly will reduce stockholder wealth. For example, suits motivated by environmental concerns or brought to halt the payment of bribes to foreign officials would, if successful, undoubtedly decrease the wealth of the firm's equity holders. Finally, some argue that the derivative suit is designed primarily to enhance the welfare of the plaintiffs,

> or the plaintiffs' counsel, and not the welfare of the firm's equityholders in general. Based on these considerations, the termination of a derivative suit might well increase the price of the firm's equity, and a continuance might decrease its market price.

Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: a Theoretical and Empirical Anaylsis*, 71 CORNELL L. REV. 261, 279 (1986).

Early settlement, even of frivolous claims, may often cost the corporation less than continuing to litigate. *See* Joseph A. Grundfest, *Why Disimply?*, 108 HARV. L. REV. 727, 742-43 (1995) (suggesting that settlement values often fall below avoided litigation costs). Conversely, delaying settlement needlessly, as Petitioners' automatic right of appeal for nonparty shareholders would permit, will impose unnecessarily high litigation costs on the corporation whose interest the derivative action was intended to protect.

The corporation, considered apart from its shareholders, directors, and officers, thus finds itself in a vise. On the one side it feels the economic pinch from fiduciaries, whose disloyalty can inflict potentially life-threatening economic damage. From the other side it feels the pinch of litigation costs. Viewed from a policy perspective, deciding how extensively nonparty shareholders may participate in derivative actions raises a potentially ticklish question of competing values. Fortunately the question has been resolved by those who drafted and enacted Rule 23.1.

II. THIS COURT SHOULD DECLINE THE INVITATION TO CREATE A RIGHT TO APPEAL WHERE RULE 23.1 IS SILENT.

A. Rule 23.1, Which Delimits the Extent of Nonparty Shareholders' Procedural Rights Regarding the Settlement of Derivative Actions, Nowhere Confers the Right of Appeal Sought by Petitioners.

Rule 23.1 of the Federal Rules of Civil Procedure (FRCP) provides in relevant part as follows:

> The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interest of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

Two preliminaries regarding Rule 23.1 are worth noting.

First, as one of the Federal Rules of Civil Procedure (FRCP), Rule 23.1 "govern[s] the procedure in the United States district courts in all suits of a civil nature." FRCP 1. That is, Rule 23.1 governs the procedure to be followed in derivative actions brought in federal district court.

Second, as with all of the FRCP, Rule 23.1 must be "construed and administered to secure the just, speedy, and inexpensive determination of every action." FRCP 1. To accomplish these ends, the Court has

declared that it "give[s] the Federal Rules of Civil Procedure their plain meaning." *Pavelic & LeFlore v. Marvel Entertainment Group*, 493 U.S. 120, 123 (1989).

The plain meaning of Rule 23.1 nowhere contains the right of appeal so urgently sought by CalPERS and SBA. Nothing in the plain language of Rule 23.1 confers on objecting shareholders an appeal as of right. The only procedural right expressly conferred on nonparty shareholders by the rule is a right to notice of any "proposed dismissal or compromise." *Id.*

Along with this right of notice comes the opportunity for a judicial hearing. However, as the drafters of the original version of FRCP cogently observed, "It must be remembered that the right to be heard is not the same as intervention . . . . One who is only given a right to be heard, and has not intervened, has no right of appeal." Levi & Moore, *Federal Intervention: II. The Procedure, Status, and Federal Jurisdictional Requirements*, 47 YALE L.J. 898, 938 (1938).

B. Petitioners' Policy Arguments Amount to An Invitation to Rewrite Rule 23.1.

CalPERS and SBA, along with their supporting *amici*, raise several policy arguments that, in essence, amount to an invitation for this Court to look beyond the plain language of Rule 23.1. Their reasons for asking this Court to invent a right of appeal where the rule is silent can be organized under the following headings:[2]

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[2] The statements contained in the headings appear to be representative of positions held by Petitioners and their *amici* collectively, since no argument to which the headings refer is exclusively raised in a single brief. In fairness, however, we point out that not every statement made in a heading appears in every

(continued...)

1. Only objecting nonparty shareholders can prevent unfair or collusive settlements in derivative actions.

CalPERS, SBA, and their supporting *amici* place great weight on the importance assigned by Rule 23.1 to objecting nonparty shareholders. "Objecting shareholders play a critical role in ensuring the fairness of derivative suit settlements." Br. Pet. at 32; Brief for the United States and the Securities and Exchange Commission as *Amici Curiae* Supporting Petitioners [*hereinafter* Br. U.S.] at 22 ("The objecting shareholders play a pivotal role in the settlement approval process . . . .").

Petitioners and their *amici* next point out that derivative actions carry the "risk that the representative plaintiff will collude with the defendant to forgo the derivative claims in exchange for a settlement that is only favorable to the representative plaintiff and his or her attorneys." 5 *Moore's Federal Practice* § 23.1.10[2][a], at 23.1-58 (1998); *see also Burks v. Lasker*, 441 U.S. 471, 485 n.16 (1979) (Rule 23.1's notice requirement is intended "to prevent plaintiffs from selling out their fellow shareholders."); J. Moore & M. Cohn, *Federal Class Actions—Jurisdiction and Effect of Judgment*, 32 ILL. L. REV. 555, 556 (1938). ("[N]otice [to nonparty shareholders] will tend to lessen strike suits by shareholders, since a shareholder and his counsel will not be able to sue and settle in the dark; and it will prevent unrighteous com promise of a just shareholders' action.").

From these premises Petitioners and their *amici* conclude, "*Only* objecting shareholders can give a

[2] (...continued)
brief.

federal court the benefit of an adversarial presentation as to whether a particular settlement is 'fair and adequate' and thus should be approved." Pet. Br. at 32 (emphasis added); Br. U.S. at 22-23 ("The objecting shareholders play a pivotal role in the settlement approval process, since they *alone* have the incentive to attempt to stop a process that builds momentum from the moment a deal is struck between the derivative plaintiff and the defendant.") (emphasis added).

In addition, Petitioners and their *amici* argue that "the efforts of non-party shareholder objectors in a wide variety of cases have resulted 'in significant improvement of the settlement.'" Br. Council at 15 (quoting WILLIAM L. CARY & MELVIN A. EISENBERG, CORPORATIONS 1057 (1988)). In support of this claim, they point to cases where objecting shareholders successfully obtained either increases in the settlement amount or reductions in the attorneys fees contained in the settlement. *See id.* (citing *In re Pacific Enters. Sec. Litig*, 47 F.3d 373, 375, 377 (9th Cir. 1995); *Alleghany Corp. v. Kirby*, 333 F.2d 327, 331-32 (2d Cir. 327); *Rosenbaum v. MacAllister*, 64 F.3d 1439, 1447-48 (10th Cir. 1995)); *see also* Br. Pet. at 33.

In effect, these statements by CalPERS, SBA, and their *amici* amount to the claim that nonparty objecting shareholders must have the right to appeal, or unfair and collusive settlements will be approved otherwise.

2. Requiring nonparty objecting shareholders to intervene in order to appeal would harm the corporation by reducing the number of objecting shareholders who contest derivative action settlements.

CalPERS and SBA next argue that "[r]equiring intervention as a prerequisite for such appeals would dramatically decrease [the number of objecting shareholders] and thereby impair the ability of objecting shareholders to serve the recognized public function of exposing, defeating, and deterring collusive or inadequate settlements." Pet. Br. at 33; *see also* Br. Council at 24 n.14 ("Even small increases in costs imposed on the monitoring function will have a substantial effect on the incentive and ability of shareholders to restrain unfair settlements."). They justify this conclusion by citing "the legal hurdles to intervention by objecting shareholders at the settlement phase," Pet. Br. at 34, and the "enormous practical disincentives." Pet. Br. at 35. Legal obstacles include the difficulty of intervening late in the proceedings, when settlement has been proposed, as well as the contemporaneous ownership rule, Br. Council at 22, which limits potential parties in a derivative suit to those who were shareholders "at the time of the transaction of which the plaintiff complains." Rule 23.1. Practical disincentives include "short notice periods," Brief of Barclays Global Investors, N.A., et al., As Amici Curiae Supporting Petitioners [*hereinafter* Br. Barclays] at 11, "lengthy procedures for making a decision to intervene," *Id.*, "small legal budgets and small legal staffs," *Id.* at 13, and the "burdens and costs associated with intervention." *Id.* at 15; *see* Br. Council at 23 ("the costs of intervention are substantial.").

This argument looks like the first, only in reverse. There the argument was that the capacity of objecting shareholders to prevent the imposition of unfair or collusive settlements justifies the creation of a right of appeal where Rule 23.1 is silent. Here Petitioners and their *amici* argue, in effect, that a judicially-created right of appeal is justified because objecting

shareholders will be prevented from challenging (supposedly) troubling settlements otherwise.

3. *Appellate review tends to render unfair or collusive settlements less likely by reversing and deterring erroneous district court settlement approvals and by rendering district courts more cautious in evaluating the objections to a settlement brought forward by nonparty shareholders.*

CalPERS, SBA, and their *amici* argue that appellate review is necessary to check the overhastiness or ignorance of district courts. "Appellate review is an essential component of shareholder participation because it provides a strong incentive for district courts to consider shareholder objections fully and a direct avenue for correcting district court errors." Pet. Br. at 33 (citations omitted).; *see also* Br. Council at 18 ("appellate review is critical to ensuring the fairness of shareholder derivative settlements"). The Council cites "correction of error," at 17, as "a powerful incentive for the district court to render more careful findings of fact and to develop a better record," *Id.*, as reasons why appellate review of derivative action settlements is desirable. "The availability of appeal also causes trial courts to consider the objections of shareholders more carefully in the first instance." Br. Council at 19.

Appellate review carries undoubted advantages. However, the arguments of Petitioners and their *amici* add up to something more negative than a natural desire to have another bite at the apple. They appear to betoken suspicion, if not outright mistrust, of district courts.

Strong arguments in favor of appellate review often come with a correspondingly strong suspicion (at times bordering on mistrust) against the sufficiency of district court judgments. That is true in this case. "The opportunity to challenge settlements of those private disputes in the district court without the corresponding right to appeal is not sufficient when there is a natural tendency among trial courts to favor approving settlements to which the named parties have agreed." Br. U.S. at 23. Appellate review will ensure "the opportunity for appellate scrutiny of what otherwise would be largely unreviewable proceedings." *Id.* at 24. The Council of Institutional Investors makes this point with particular force. Although Rule 23.1 imposes on district courts the duty to evaluate whether a proposed settlement serves the interests of the corporation, the Council opines that "a district court may be poorly situated to fulfill this duty on its own." Br. Council at 12. The Council cites two reasons for suspecting the capacity of district courts, neither of which casts them in a flattering light. "[I]n considering a settlement proposal, a district court may have relatively limited knowledge of the underlying action" *Id.* at 12-13. "[T]here is a strong institutional bias in favor of settlement" *Id.* at 13.

All of these arguments in favor of appellate review can be interpreted in two ways. They can be read to mean that the virtues of appellate review, including error correction, deterrence of future error, and promoting greater sensitivity of district courts toward nonparty shareholders during the settlement hearing, justify the Court in finding a right to appeal that the plain language of Rule 23.1 does not contain. Or the arguments can read to mean that suspicion (or mistrust) of district courts and their capacity (or willingness) to smoke out and reject unfair or collusive settlements

justifies the creation of a right of appeal for objecting shareholders. Either way calls for the Court to rewrite Rule 23.1 to include a right of appeal on which the rule as written is silent.

C. Rule 23.1 Provides Adequate Protection Against Unfair or Collusive Settlements in Derivative Actions.

Despite the various fears expressed by Petitioners and their *amici*, Rule 23.1 adequately protects corporations against unfair or collusive settlements in derivative actions. Such protection includes the requirement of judicial approval before any derivative action may be "dismissed or compromised," FRCP 23.1, and notice to every shareholder of the proposed settlement. *See id.* The drafters of the rule erected these safeguards against the collusive and unfair settlements so frequently cited by CalPERS, SBA, and their *amici* as a cause for concern. *See, e.g., Birnbaum v. Birrell*, 17 F.R.D. 409, 411 (S.D.N.Y. 1955).

In addition, objecting nonparty shareholders hold significant rights, even without the right of appeal sought by Petitioners. They "must be allowed to have meaningful participation at a settlement hearing," including "certain rights to discovery and cross-examination on issues pertaining to the settlement." 5 *Moore's Federal Practice* at § 23.1.10[1][c].

These procedural protections are adequate, if not perfect. It may be true that another level of judicial scrutiny would improve, even substantially improve, the quality of settlements in derivative suits. But the those who drafted and enacted the rules did so with an apparent intent to accommodate competing interests.

Derivative actions primarily serve the interests of corporations, who often benefit from early and inexpensive settlement. Corporations' interest in achieving settlements is favored by the law. *See, e.g., McDermott v. Amclyde & River Don Castings Ltd.*, 511 U.S. 202, 215 (1994) ("public policy wisely encourages settlements"); *Armstrong v. Board of Sch. Directors*, 616 F.2d 305, 312 (7th Cir. 1979) ("It is axiomatic that the federal courts look with great favor upon the voluntary resolution of litigation through settlement."). At the same time, settlements in derivative actions must avoid unfairness and collusion. *See, e.g., Birnbaum v. Birrell*, 17 F.R.D. 409, 411 (S.D.N.Y. 1955).

Rule 23.1 accommodates these competing concerns. On the one hand, it discourages unfair and collusive settlements by requiring prior notice to all shareholders, including nonparties, and by requiring prior judicial approval. On the other hand, it does not discourage settlement by imposing strenuous requirements, such as the unanimous consent of all shareholders or the successful appellate review of each proposed settlement. The procedural regime established by Rule 23.1 adequately protects the interests voiced by Petitioners without ignoring the competing interests at stake.

D. If Rule 23.1 Requires Amending, this Court Ought to Leave the Task to the Rulemaking Procedure that Congress Has Prescribed.

Even if every policy argument raised by CalPERS, SBA, and their *amici* were correct, this Court should still decline the invitation to amend Rule 23.1 through judicial legislation. Rule 23.1 does not contain words that can be fairly interpreted to include a right of appeal for nonparty shareholders who wish to appeal from

a district court's decision to approve the settlement of a derivative action. The only alternative is for the Court to rewrite the rules, which it has repeatedly—and rightly—refused to do.

Only last year, in *Amchem Products, Inc. v. Windsor*, 117 S. Ct. 2231 (1997), the Court addressed whether federal courts may certify a class under FRCP 23 if they consider a settlement "fair," even if the class does not meet the test outlined in Rule 23(a) and (b). The answer was a resounding "No."

> [C]ourts must be mindful that the rule as now composed sets the requirements they are bound to enforce. Federal Rules take effect after an extensive deliberative process involving many reviewers: a Rules Advisory Committee, public commenters, the Judicial Conference, this Court, the Congress. . . . The text of a rule thus proposed and reviewed limits judicial inventiveness. *Courts are not free to amend a rule outside the process Congress ordered . . . .*

Amchem Products, Inc. v. Windsor, 117 S. Ct. 2231, 2248 (1997) (citations omitted) (emphasis added); *see also Omni Capital Int'l v. Rudolf Wolff & Co.*, 484 U.S. 97, 111 (1987) ("It is not for the federal courts, however, to create such a rule as a matter of common law. That responsibility, in our view, better rests with those who propose the Federal Rules of Civil Procedure and with Congress").

Amendment, when necessary, has been left open by the rulemaking process prescribed by Congress. *See* 28 U.S.C. § 2072 (1998). And that avenue has been regularly put to use. The Federal Rules of Civil Procedure were adopted or amended 64 times between

1962 and 1993. Order, 507 U.S. 1091, 1092 (1993). There is no need for the Court to invent a right of appeal where Rule 23.1 is silent. If necessary, Rule 23.1 can be amended again, properly—through the procedure ordained by Congress.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted,

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